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Directorate of Intelligence

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International
Economic & Energy
Weekly

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30 November 1984

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	International Economic & Energy	
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	Synopsis	
1	Perspective—Creditor Views on LDC Financial Prospects	25X
	International bankers are more optimistic than they were several mabout LDC financial problems. Despite the more favorable econom ment, however, bankers admit their reluctance to extend many new LDCs.	ic environ-
15	International Financial Situation: Status of Bank Lending to LDCs	
	Commercial bank lending to LDCs remains depressed, reflecting or reluctance to lend to debt-troubled countries and reduced LDC ext financing requirement. Bankers continue to reassess lending strateg urging LDCs to seek funds elsewhere, particularly from official cre foreign investors.	ernal ies and are
19	West Germany: Steel Restructuring	25 X 1
	The recently announced merger between Kloeckner-Werke and Kr Germany's second- and fourth-largest steel companies, is the first s a much-needed consolidation of Western Europe's largest national industry.	tep toward
23	Australia's Economic Recovery: Hawke's Election Trump Card	25X1
	Australia's popular Prime Minister, Bob Hawke, is relying on a reseconomy to guarantee his party's victory on 1 December.	
27	Egypt: Nuclear Power Program Falters	25 X 1
	Lack of cash or a decent credit rating is thwarting Egypt's attempt nuclear power program. Low domestic energy prices would make it for a nuclear power project to pay for itself.	
31	Mexico: Border Assembly Operations Expanding	 25 X 1
	The peso devaluations since the beginning of 1982 and favorable to from the de la Madrid administration have spurred the growth of as erations along the US border. The expansion may be short lived, he to labor shortages, inadequate physical facilities, and increasing contracts to the contract of the property of the period	sembly op- wever, due
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	on LDC Financial Prospects	25
	International bankers are more optimistic about LDC financial problems than they were several months ago. They point to stronger LDC liquidity positions, continued financial adjustment by debtors, increased LDC exports, declining international interest rates, and a softening in the oil market for their upbeat outlook. Much of the talk about alternate solutions to the debt crisis—such as capitalization of interest—has faded. European bankers favor the current case-by-case approach because of its success. Despite the more favorable economic environment, however, bankers admit their reluctance to extend many new credits to LDCs.	2
	Because commercial banks are hesitant to lend, debtors will be seeking more bilateral and multilateral assistance.	2
	debt-troubled LDCs are strong proponents of boosting the lending resources of multilateral institutions, particularly the World Bank and the Inter-American Development Bank. Many members of the international financial community are looking to the World Bank to take a more active role in LDC development.	2
	financial flows to debtor countries will rebound in several stages if these countries continue to restore their creditworthiness. The first stage would be a recovery in trade financing by the commercial banks. We are already beginning to see signs of growth in short-term, trade-related credits to Mexico and Brazil. The next would entail a renewal of long-term financing from banks, governments, and multilateral institutions. Should confidence within the financial community continue to grow, LDCs could expect increased equity investment. Additionally, for those LDCs with good economic performance and a generally stable political situation, another wave of funds	2
	could come from the repatriation of flight capital.	25
	To restore confidence, the debtor countries must continue economic adjustment. The case-by-case approach to the LDC debt problem has been successful primarily because countries have undertaken austerity measures. As LDCs move to export their way out of financial problems, they also must adjust structurally to sustain this export growth. With flexibility and creativity, the international financial community should be able to ease the adjust-	

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not believe the financial community will provide the funds needed for marked rebounds in LDC growth rates.	25X1
Progress toward resolution of the debt problem could be threatened by external factors. In the event of sharply rising interest rates, slowing OECD growth, increased OECD trade restrictions, or a major oil shock, the financial needs for some countries would grow to levels that lenders would be unwilling to finance. Progress could be thwarted by reactions within debtor countries to continued outflows of capital. In particular, we believe political leaders in Latin America probably will come under increasing pressure to stem the net outflow. At this time, a net inflow of funds could only be achieved with a more rapid growth of exports, a dramatic drop in dollar-related interest rates, or	•
interest payment relief.	25 X 1
	25 X 1

ment through bank lending, direct investment, and official flows. Still, we do

Briefs

OPEC Production Update

Energy

OPEC production averaged 16.9 million barrels per day (b/d) in October, and, despite the organization's decision last month to reduce quotas to restore stability to the market, preliminary indications are that November output will top the cartel's self-imposed 16-million-b/d ceiling. Nigeria, Iraq, Indonesia, and the UAE have been the principal violators, and the majority of other members are merely paying lipservice to newly assigned quotas. The US Embassy reports that Indonesia does not intend to abide by OPEC's month-old agreement. Overproduction and a rash of price discounts by the UAE, Iran, and Indonesia continue to undermine OPEC's official price structure and, are partly responsible for the recent sharp drop

in spot prices. OPEC's lack of commitment to its latest accord casts serious

OPEC Production a

Million b/d

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	Quota	1984			
•		Third Quarter	October	November	
Total	16.000	17.0	16.9	16.3-17.0	
Algeria	0.663	0.7	0.7	0.7	
Ecuador	0.183	0.2	0.3	0.3	
Gabon	0.137	0.2	0.2	0.2	
Indonesia	1.189	1.4	1.4	1.4	
Iran	2.300	2.2	1.9	1.8-2.1	
Iraq	1.200	1.2	1.3	1.3	
Kuwait	0.900	0.9	1.0	0.9	
Libya	0.990	1.1	1.0	1.0	
Neutral Zone	ь	0.5	0.5	0.4	
Nigeria	1.300	1.2	1.5	1.5	
Qatar	0.280	0.4	0.4	0.4	
Saudi Arabia	4.353 ◦	4.0	4.0	3.6-4.0	
UAE	0.950	1.2	1.1	1.1	
Venezuela	1.555	1.8	1.8	1.8	

a Preliminary.

b Neutral Zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.

c Saudi Arabia has no formal quota; it acts as swing producer to meet market requirements.

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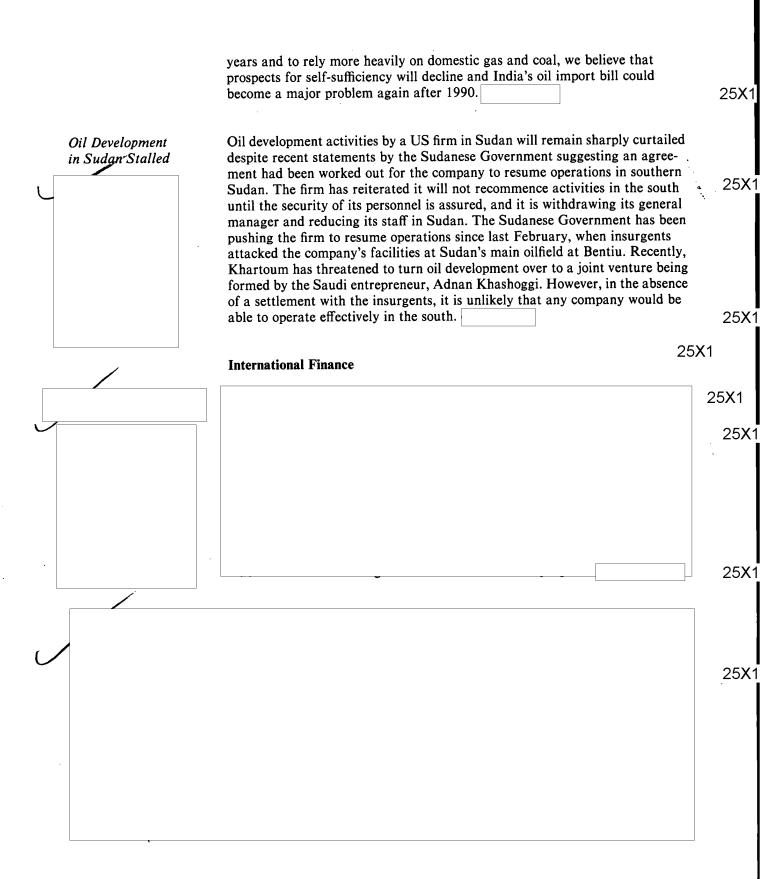
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	doubt on the organization's ability to forestall a price drop in the next few weeks and raises even more serious questions about defending prices early next year.
Spot Oil Market Trends	Spot prices for most crudes have fallen 25 to 75 cents per barrel in the past week. The spot price for the benchmark Arab Light crude now approximates \$27.35 per barrel, \$1.65 below its official price, and prices for two other key crudes—Brent and West Texas Intermediate—also respectively are about \$1.65 and \$1.50 below official levels. According to press reports several OPEC members have not adhered to the terms of OPEC's October accord and have offered substantial price discounts to market additional oil. Persistent price weakness already has forced several major US oil companies to reduce posted prices, and many industry sources speculate that North Sea oil producers—particularly Norway—will be forced to cut official prices an additional 30 to 60 cents per barrel unless spot prices strengthen appreciably in coming days. We believe the unseasonably warm weather so far this year and expectations of further price reductions have caused buyers to defer purchases. Any further price cuts by non-OPEC producers probably would spur additional reductions by Nigeria or other OPEC producers.
Indian Petroleum Prospects Dim	India's drive toward petroleum self-sufficiency will begin to lose momentum next year, according to the US Embassy. Sharp rises in output from the offshore Bombay High field since 1982 have almost tripled domestic produc-



EC Cancels Steel Accord With United States

Global and Regional Developments

The EC has renounced its 1982 agreement to limit exports of steel pipes and tubes to the United States. The move came in response to US rejection of an EC offer to reduce its current share of the US market to 7.6 percent. For the first nine months of this year, EC pipe and tube exports to the United States leaped 92 percent compared with the same period a year ago, in part because of the dollar's strength; the Community now accounts for 14 percent of the US pipe and tube market. The 1982 agreement pledged to limit pipe and tube shipments to 5.9 percent of the US market but had no enforcement provisions. Without a negotiated agreement, EC pipe and tube exports will face a unilateral US embargo for the remainder of the year and in 1985 be limited to 5.9 percent of the projected US market, or roughly 560,000 tons. The EC is threatening retaliation—it is already seeking compensation through the GATT—but the Community probably would prefer to return to the bargain-

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ing table to avoid escalation of the dispute.

West Germany Extends Territorial

The West German Cabinet earlier this month confirmed the planned extension of West German territorial waters in Helgolander Bay on the North Sea from 3 nautical miles to 16 nautical miles. To prevent oilspills from tanker accidents, Bonn is planning new traffic regulations and a new radar system for the area—one of the world's busiest shipping lanes. The extension is to take effect in three to four months. The original October 1983 decision had been under review because of US objections that the decision would create a precedent for other extensions, which might hamper the freedom of movement of Western naval forces and merchant vessels. Recent publicity surrounding the Law of the Sea Convention and heightened environmental pressures, however, led to the Cabinet decision, which was made on short notice and reportedly without consideration of alternative proposals.

Kenewed CEMA-EC Trade Talks

The EC is deflecting new CEMA efforts to negotiate a bloc-to-bloc trade agreement. The CEMA summit last June agreed to attempt to revive moribund negotiations with the EC for an umbrella agreement and chose Bulgaria to make the approach. The Bulgarian Foreign Trade Minister accordingly told EC Vice President Haferkamp late last month that CEMA was flexible on terms and procedures. The Bulgarian stated that, after the umbrella agreement is reached, CEMA countries could sign separate accords with the EC, as Romania did in 1978. Haferkamp responded that the EC still awaits a written reply to its March 1981 letter and that the EC sees little value in a framework agreement with CEMA.

The EC Commission almost certainly will proceed cautiously. The Community probably continues to prefer negotiating trade agreements with individual East European countries. EC members also may be concerned that an EC-CEMA agreement would widen trade deficits with Eastern Europe. The Sovietinitiated CEMA proposal might—as perhaps originally intended—slow the

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	efforts of some East European countries to deal directly with the EC. The East Europeans, however, are likely to resume such talks when the failure of CEMA-EC talks again becomes apparent.
LICCD Consucthaning	Iraq has awarded the USSR a
USSR Strengthening Economic Ties With Iraq	\$200 million contract for a gas pipeline to connect Iraq's southern Ar Rumaylah oilfield to Baghdad. Earlier this year Moscow extended Baghdad a \$2 billion credit for the construction of two thermal power stations, the development of an oilfield, and the purchase of Soviet weapons. Iraqi civilian imports from the USSR since the war began total roughly \$1 billion.
	Iraq's economic difficulties make Baghdad willing to forgo the advanced Western technology for more attractive credit terms. Dependence on Soviet weapons could be an additional incentive to look favorably on Soviet bids for economic projects. Nevertheless, Baghdad remains wary of Moscow's intentions and probably will restrict economic deals to electric power, communications, and energy projects— areas in which the USSR is already deeply involved. Iraq still imports about three-fourths of its civilian goods from the West and is likely to rely primarily on Western firms to rebuild its economy.
	National Developments Developed Countries
British Economic Policies To Remain Tight	London's recent expenditure statement confirms Prime Minister Thatcher's commitment to tight fiscal and monetary policies. To hold real public spending steady next year, spending increases in some programs, including EC contributions, will be balanced by decreases in others. Despite a nearly \$1 billion overrun in the projected budget deficit this fiscal year, which Chancellor of the Exchequer Lawson attributes to the ongoing miners strike, London hopes to implement a \$2 billion tax cut in the next budget. An end to the strike would improve the current account deficit as coal and steel exports recover and oil imports to offset coal losses cease. Budget critics, however, are likely to point to the lack of measures to stem rising unemployment—currently 13 percent.
	The Treasury has presented an optimistic forecast of 3.5 percent for FY 1986 economic growth—assuming complete recovery from the costly miners strike, which shaved an estimated 1 percentage point off growth in FY 1985. Lawson claims that 3.5-percent growth will bring public spending as a share of GDP down to 41 percent—its lowest level in 6 years. Most forecasters, however, estimate real growth next year at only 3 percent as low inflation, falling

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sluggish consumer spending.

interest rates, and a record low pound boost investment and exports, offsetting

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Despite earlier Cabinet pressure, London has announced the defense budget for 1985/86 will not be affected by the latest round of government spending cuts. The US Embassy reports that defense spending is projected to increase by 2.8 percent in real terms in the next fiscal year. No real increases are projected after 1985/86. The 2.8-percent projection of real growth, however, is based on a 4.5-percent increase in defense costs. If, as is likely, defense costs grow faster than the overall inflation rate, this target will not be met. According to the Embassy, even most Conservatives are convinced that defense is taking up enough of the government budget, and Defense Secretary Heseltine avoided projected spending cuts in future years only by abandoning his call for continued real growth after 1985/86. Preservation of 1985/86 spending levels will strengthen Prime Minister Thatcher's goal of maintaining current NATO commitments and modernization programs, including the Trident missile program.

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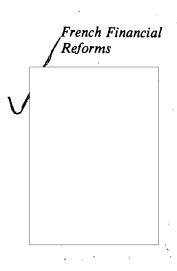
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Finance Minister Pierre Beregovoy has announced three small reforms of the financial system in the past month that signal a modest step toward a more market-oriented approach. A system of progressive reserves and capital ratios will replace bank-by-bank credit ceilings, which limited competition between banks. The government will still favor certain types of loans, such as exports and industrial investment and, according to the US Embassy, most bankers think this first step may actually tighten credit. Foreign exchange controls have also been eased. French nationals may now send about \$160 abroad monthly rather than quarterly. French companies will be allowed to finance 50 percent of investments within the EC from domestic sources rather than 25 percent, and EC institutions will be given greater access to French financial markets—especially for European Currency Unit issues. This move probably reflects an improving foreign payments position, and rules can be tightened again if necessary. Several forms of subsidized credit will be eliminated and replaced by market rate loans. Although this reform will reduce costs to the government, it is not likely to reduce greatly the total amount of loans granted through government channels.

West German Surtax
Declared
Unconstitutional

West Germany's constitutional court earlier this month ruled against a 1983 surtax on upper-bracket taxpayers. The 5-percent "forced loan," earmarked for housing construction, was to be levied on 1983-85 tax liability and repaid without interest during 1990-93. The \$700 million in refunds will provide a welcome stimulus to holiday retail sales. Bonn can easily cover the revenue loss.

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	Japanese Planners See Growth Continuing in 1985	A preliminary forecast by Japan's Economic Planning Agency (EPA) puts real GNP growth for fiscal year 1985 (beginning next April) at 4.6 percent, down from this year's projected 5.3 percent. With exports likely to slow next year, the economy will have to depend increasingly on domestic demand. Investment is forecast to increase by 8 percent, down from this year's estimated 10 percent. Private consumption—over half of GNP—is expected to rise by 4 percent, about the same as this year. Despite the export slowdown, Japan's current account surplus—running at record levels this year—is not likely to be reduced, according to the forecasters. A separate EPA forecast, based on the EPA's world model, shows growth of 4.1 percent in 1985. The Ministry of Finance is pushing the EPA for a lower final forecast, hoping to point to expected lower government revenues to justify a tighter budget to help reduce the persistent deficit.
ب		
_	Anothér Israeli Inflation Record	Israeli consumer prices rose by 24.3 percent in October, breaking the record for the second straight month. The annual rate based on the first 10 months of the year hit 491 percent. Under the terms of the wage-price freeze agreement signed in October, workers will receive a cost-of-living adjustment of only 12.9 percent on wages paid on 1 December; previously the adjustment would have been 19.4 percent. Israeli officials expect the 3-month wage and price freeze will dampen inflation in November and December.
	Israel Cracks Down on West Bank Moneychangers	The Israeli Government has ordered unlicensed West Bank moneychangers to close down and licensed moneychangers to deal only in shekels and Jordanian dinars. While dinar transactions now require a Jordanian passport, many West Bankers who convert their depreciating shekels daily into dinars, do not have passports. In addition, West Bankers, who are allowed to bring up to \$5,000 with them when entering the West Bank from Jordan, must now deposit those funds in Israeli banks within 48 hours. By these new measures, the Israelis are trying to stem illegal purchases of US dollars, which the US Consulate in

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Tough New Zealand Budget

for Ethiopia

Jerusalem estimates exceed \$100,000 per week. They will not succeed unless the crackdown is also applied to Jewish moneychangers in Tel Aviv and Jerusalem. Moreover, the recent moves, if actually enforced, will undercut Prime Minister Peres's stated aim of trying to improve the Palestinians' quality of life in the occupied territories.

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The Lange government's first budget—for the fiscal year ending in March 1985—is a political gamble designed to tackle the country's serious economic problems, particularly a burdensome US \$2.1 billion budget deficit. According to the US Embassy, Lange wants to get painful reform measures in place quickly, while his popularity—recently recorded at 75 percent—remains high. The new budget raises the average income tax rate and imposes increased duties on cigarettes, alcohol, gasoline, and electric power, while reducing subsidies to farmers and manufacturers. Increased social benefits, however, are expected to boost government spending more than 9 percent, offsetting some of the revenue gains. Although some party stalwarts are unhappy with the tax reform measures, domestic economists are praising the efforts to reduce the deficit and support the emphasis on free market pricing policies.

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Less Developed Countries

oviet Famine Relief

Despite its provision of equipment to transport famine relief supplies in Ethiopia, Moscow has not altered its tough stand on economic assistance or disaster relief. Ethiopia has agreed to Moscow's demands that Soviet aircraft be fueled at Ethiopian expense, according to a US Embassy source. The Soviet Ambassador, in acrimonious talks with a senior Ethiopian Workers' Party official, required per diem reimbursement for Soviet Air Force personnel. The USSR's tightfisted approach is typical of its economic aid practices. It has tried to use its logistic support for the relief effort to make Western aid seem less important, to forestall Ethiopian acceptance of Western transportation offers, and to convince the Ethiopian people that the USSR, not the West, is providing most of the food. During Ethiopian ceremonies for the Revolution's Tenth Anniversary, however, Politburo member Romanov pointedly disavowed Soviet responsibility for Ethiopia's economic plight, recalling examples of the USSR's self-reliance during its early years.

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Exports Remain High

Nicaragua's Banana

Despite insurgent activity, Nicaragua's banana exports are moving briskly.

as of mid-November, Nicaraguan banana exports
were averaging 2,000 metric tons per week—about 40 percent above the rate
for the first nine months of 1984. If exports continue at the mid-November
rate, we estimate that total 1984 banana exports will reach 75,000 tons valued
at around \$25 million, compared with about 62,000 tons valued at \$20.2
million in 1983, and only 38,000 tons valued at \$9.6 million for 1982. US imports of bananas from Nicaragua for the period of January-September totaled

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	nearly 51,000 tons, valued at \$17.4 million. Although Nicaraguan bananas represent only about 4 percent of total US imports, the US market represents the bulk of the export market for Nicaragua.	25X1
	While plantations in the main growing region of Chinandega Province have not suffered damage from rebel activity, banana production next year and beyond could be hurt by the current lack of spare parts for equipment and machinery. Worker efficiency reportedly also is	25X1
	suffering from a scarcity of foodstuffs, medicine, and clothing.	25X1
Indonésia Pressuring Foreign Investors	Manpower Minister Sudomo's heavyhanded pressure on a US-owned firm to accept a union at its semiconductor plant in Jakarta may damage Indonesia's investment climate. Earlier this month, Sudomo stated that the law requires the company to accept a union immediately. Company officials have said they are willing to obey the law but believe most of their employees do not want a	25X1
	union.	25X1
	According to the US Embassy, even though the outcome of the case against the firm—one of two US semiconductor firms producing solely for export—could have been foreseen, it will discourage other potential foreign investors.	
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Afghan Food Price Increases	Price increases for basic food items in Kabul have been moderate over the last two years, but prices in the countryside have risen rapidly. Market surveys by US Embassy officers during October indicate that the average price of basic food items in Kabul is about 16 percent higher than two years earlier, although vegetable oil and lamb prices increased by 64 percent and 29 percent, respectively. Surveys taken in provinces outside Kabul indicate prices for staples have risen by more than 25 percent annually in most areas, no faster than prices of nonfood items. The increase in Kabul is modest, given the war. The Soviets have made sizable food deliveries to Kabul to help ensure a degree of normality in daily life. Food prices for many in the capital are heavily subsidized by the government, which has its costs underwritten by the Soviets.	25X1
	While some price increases for food in areas outside Kabul are caused by shortages, we believe the inability of the government to dictate prices, the rapidly growing money supply, and spiraling transportation costs also are	25 X 1
Pakistani Five-Year Plan Scrapped	Planning Minister Mahbub-ul-Haq announced last week that the five-year economic development plan (1983-88) would be replaced by a rolling three-year plan. According to the US Embassy, growth targets will be revised downward and several projects, including the Chasma nuclear power plant, would be deferred. The scrapping of the plan, barely into its second year, reflects the slowdown in the economy over the past year and the government's continuing difficulty funding development projects. Last year's disastrous	
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cotton crop resulted in negative growth in the agricultural sector, and worker remittances began to decline for the first time since the early 1970s, probably because of declining job opportunities in the Middle East for Pakistani workers. One of Islamabad's next steps probably will be to request additional assistance from Western aid donors.

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New Sri Lankan Budget To Promote Exports

Sri Lanka's CY 1985 budget announced last week focuses on export and private-sector incentives through a major revamping of the tax and tariff system. Colombo plans to reduce most import tariffs, lower export taxes on plantation crops—tea, rubber, and coconuts—and extend tax holidays for nontraditional export industries. Over time, the new tax package is expected to raise revenues, mainly through increased exports and economic growth. During the next year, however, added expenditure for development projects, debt service, and internal security is estimated to raise the budget deficit about 9 percent in real terms compared with 1984. Despite these incentives for domestic and foreign entrepreneurs, new investment is constrained by lack of attractive opportunities and political instability stemming from the continued Tamil insurgency.

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Communist

Soviet 1985 Ecénomic Plan The economic goals for 1985 announced to the Supreme Soviet this week indicate Moscow is looking for a rebound in economic growth over the expected 1984 results. Planning chief Baybakov revealed that agricultural output fell this year, but he expressed general satisfaction with results in most other sectors of the economy. He emphasized the consumer-oriented aspects of the 1985 Plan, citing the rising share of industrial output accounted for by consumer goods and large expenditures on health, housing, and education allocated for next year.

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The implied growth rate of 3.5 to 4.0 percent for GNP next year is extremely ambitious. The target for agriculture is not beyond reach, but it will require much better weather than in recent years. Industry will have to grow at this year's relatively healthy pace, which will require productivity gains at least as great as those in recent years and greater savings of energy and metals. The plan also calls for much larger additions to plant and equipment, while cutting back the rate of investment growth. Despite Baybakov's consumer emphasis, the plan could accommodate faster growth in defense spending. The target for the machine-building sector, in particular, is high enough to support a rise in the production of military hardware.

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Average annual growth in percent

	1981	1982	1983	1984 nary) (Projected)	1985 (Planned)
GNP	1.9	2.5	3.2	2.3	3.5-4.0
Industry	2.4	2.3	3.4	3.5	3.9 a
Agriculture	-0.1	6.1	6.3	-1.0	6.7.a

a Official Soviet figure.

USSR: Economic Indicators

The USSR has solicited bids from several Western firms for a large petrochemical Technology.

The USSR has solicited bids from several Western firms for a large petrochemical complex at Budenyenovsk in the north Caucasus. The complex probably will cost over \$500 million and will be financed on a compensation basis. Planned for 1986-90, it will increase substantially the USSR's capability to produce plastics. Annual capacity of the major units will be 250,000 metric tons of ethylene, 200,000 tons of linear low-density polyethylene (LLDPE), 100,000 tons of polypropylene, 50,000 tons of polybutylene, and 60,000 tons of compounded polyolefines. Polypropylene from the complex will be used by an electrical devices plant recently ordered from France. This turnkey project

East German Gredit Increased

East Germany's previously announced six-year credit of \$150 million has been raised to \$400 million

underscores the continuing dependence on Western technology. The USSR is

seeking US technology for the LLDPE plant, which is its first.

The deal is to be signed on 21 December and will be the largest commercial loan to an East European country since 1980. Terms include interest at 1 percentage point over LIBOR and a three-and-a-half-year grace period, making it more attractive than last summer's "jumbo" loan guaranteed by Bonn. The heavy oversubscription follows two smaller credits announced recently and indicates East German success in reentering medium-term credit markets.

We believe East Germany will use the funds primarily to lenghten the maturities of its debt and is likely to seek several medium-term credits next year to further improve the maturity structure. Midyear figures of the Bank for International Settlements show another quarterly rise in reserves, to \$4.2 billion, while net debt again fell, and we believe another reduction in East German debt next year is likely.

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China Sells Recently the Bank of China issued Japanese yen-denominated bonds worth Samurai Bonds about US \$83 million for sale on the Tokyo Stock Exchange—the first time the Bank has ever made a public offering. The bonds will carry an interest rate of 7 percent, only a fraction above those issued by the Japanese Government, a reflection of the "AAA" rating the Bank has received from Japan's credit rating institutions. Over the past three years, organizations such as the China International Trust and Investment Corporation and provincial trust corporations have issued about \$200 million worth of private placement bonds in Japan and Hong Kong, but, presumably, none of these had the full backing of the Chinese Government. If the issue is fully subscribed, China probably will be encouraged to sell bonds in other markets, including the United States. The recent decision of the Alabama court to throw out the Huguang Railway Bond case clears the way for such an issue.

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International Financial Situation: Status of Bank Lending to LDCs

Commercial bank lending to LDCs remains depressed, reflecting creditor reluctance to lend to debt-troubled countries and reduced LDC external financing requirements. Net bank lending to LDCs at the end of June was only 2 percent—about \$6 billion—higher than at yearend 1983, according to recent Bank for International Settlements data. This was nearly the same rate of increase as in the first half of 1983, but bankers do not expect a repeat of last year's strong second-half performance, which brought the yearly increase in lending to about 8 percent, or \$25 billion.

Bankers continue to reassess lending strategies and are urging LDCs to seek funds elsewhere, particularly from official creditors and foreign investors.

Syndicated Lending in 1984

Medium- and long-term syndicated lending to LDCs is continuing the downward trend begun in 1982 following the advent of the debt crisis. Several major patterns in syndicated lending in 1984 are evident:

- Over 40 percent of new medium- and long-term credits have been tied to debt-rescheduling packages. Nearly all of this "involuntary" lending went to Latin American debtors. Most other lending went to Asian and OPEC borrowers.
- Asian countries in general continue to attract the most favorable loan terms among LDCs. Malaysia and Thailand, for example, have been able to obtain spreads of less than 0.5 percentage point above LIBOR. Indonesia and South Korea, because of the magnitude of their external debt, have had to accept higher spreads but still are getting an average of 0.75 percentage point above LIBOR.

LDC Debt Owed to Western Banks

Billion US \$

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	December 1982	December 1983	June 1984
Total LDCs	319.2	344.3	350.2
Latin America	196.8	208.0	210.0
Of which:			
Argentina	22.2	24.5	23.6
Brazil	56.1	58.8	61.8
Chile	10.4	11.7	11.8
Colombia	5.5	6.0	5.7
Ecuador	4.1	4.3	4.2
Mexico	59.0	64.4	65.8
Peru	5.2	5.2	5.1
Venezuela	22.7	22.8	22.2
Asia	52.9	57.7	59.9
Of which:			
India	1.6	2.1	2.2
Indonesia	6.2	7.7	8.5
Malaysia	4.6	6.0	6.6
Philippines	8.3	8.3	8.9
South Korea	18.8	19.5	19.4
Taiwan	5.2	4.7	4.8
Thailand	3.0	4.1	3.8
Middle East	37.5	45.2	47.4
Egypt	4.3	5.8	6.5
Africa	32.0	33.4	32.9
Of which:			
Algeria	6.5	6.7	7.0
Ivory Coast	2.9	2.8	2.7
Morocco	3.6	3.8	3.8
Nigeria	7.0	8.5	8.1

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LDC Syndicated Cree	dits a	Billion US \$

	1983	1984
<u>-</u>		(Jan-Oct)
Total	37.5	27.4
Non-OPEC	30.8	24.6
Of which:		
Argentina	1.8	0
Brazil	4.6	6.5
Chile	1.4	0.8
Colombia	0.4	0.2
Hong Kong	0.8	0.8
India	0.8	0.4
Malaysia	1.6	1.2
Mexico	5.1	3.8
Peru	0.5	0
Philippines	0.7	0
South Korea	3.7	3.4
Taiwan	0.3	0
Thailand	0.4	0.4
OPEC	6.7	2.8
Of which:	• • • • • • • • • • • • • • • • • • • •	y y
Algeria	1.7	0.3
Ecuador	0.4	0 -
Indonesia	2.0	1.7
Nigeria	0.2	.0
Saudi Arabia	0.5	0.5
Venezuela	0.2	0

a Publicized medium- and long-term loans from commercial banks.

• The total interest cost on new syndicated loans has increased by about 1.4 percentage points in 1984. The average spread for LDCs has fallen slightly, but LIBOR has risen from an average of 9.6 percent in 1983 to 11.1 percent in 1984. The average maturity on LDC credits lengthened slightly from six to seven years.

Latin American borrowers remain unable to obtain many new syndicated credits outside of rescheduling packages. Brazil, Chile, and Mexico have received new money in conjunction with their IMFsupported programs but have obtained only a few

small, additional credits. Mexico recently failed to
raise a \$50 million loan on international capital
markets. Argentina and Venezuela, once major
borrowers, have been inactive in 1984; Argentina is
attempting to line up new funds along with its IMF
program and rescheduling efforts, while Venezuela
did not seek any new money to better sell its
rescheduling package. Colombia, which was the
last major South American borrower to be consid-
ered a good credit risk, has seen lending fall off
because of problems in its banking sector and
general creditor concern about the region.

Among the major Asian debtors, South Korea continues to borrow heavily, but commercial banks are becoming more concerned about South Korea's short-term debt—about \$12 billion—and are more hesitant about new medium-term loans without a rise in the spread. Indonesia and Malaysia have been active borrowers, taking advantage of their relatively good credit ratings. The Philippines, meanwhile, has not obtained any new syndicated credits this year but is rescheduling its debt and seeking new money for 1985.

Most other major LDC borrowers have been relatively inactive in 1984. Algeria, after lining up \$1.7 billion in 1983, has been a minor borrower. Nigeria has yet to obtain any new credits this year because of its unwillingness to agree to an IMF-supported adjustment program as the precursor to a debt-restructuring package.

Outlook for 1985

The prospects for commercial bank lending to LDCs probably will not improve over the next year.

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Much of the new bank lending for 1985 will again be linked to IMF-supported financial packages. A number of major debtors are already lining up new funds, seeking a total of \$9-12 billion:

- Brazil began negotiations in mid-November with commercial banks on debt rescheduling and new money for 1985. Bankers have indicated that Brazil is not seeking any medium-term new money but is instead pushing for a \$4 billion increase in short-term trade credit lines. Bankers generally believe that this would be an easier package to sell to the large group of creditor banks. Creditors expected negotiations to carry over until after the presidential elections in January.
- The Philippines is seeking \$925 million in new money from banks and is attempting to sell the package to the individual creditor banks. Manila needs to obtain commitments for 90 percent of the money before the IMF will approve a standby program, a level that can be reached with commitments from the top 100 of the over 480 foreign creditors.
- Argentina, like the Philippines, needs new money commitments from commercial banks before obtaining an IMF agreement. Argentina originally requested \$5.5 billion, but bankers have stated that \$3.5 billion is the limit. Buenos Aires had hoped to obtain the commitments by the end of November, but negotiations probably will continue into December.

• Ecuador has indicated that it will need \$500 million in new money from banks in 1985 as opposed to the original estimate of \$350 million,

	Bankers
generally are pleased with Ecuador's per	form-
ance but are reluctant to provide an addi	tional
\$150 million because of the many other i	new
money requests from Latin American co	untries.

Among other debt-troubled LDCs, Mexico is attempting to avoid any new borrowing from commercial banks in 1985, but some bankers doubt that Mexico will be successful. Venezuela will not be able to raise new money until its restructuring package is signed. Nigeria and Peru each will have to reach agreement with the IMF before any new bank lending will be provided.

Most Asian debtors will continue to attract new credits, but we believe banks will be more cautious in their lending toward the larger debtors, particularly South Korea, Indonesia, and Malaysia. Many smaller banks want to get out of international lending and may be unwilling to lend even to the relatively good LDC credit risks.

The slower growth of bank lending will push LDCs to turn to official sources—Western governments and multilateral institutions—to fill any funding gaps. Official creditors, however, thus far have not been willing to substantially boost their share of LDC lending. If this pattern remains unchanged, LDCs would be forced to undertake more serious structural adjustment in their economies to improve growth prospects.

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	Germany:	
Steel	Restructuring	

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The recently announced merger between Kloeckner-Werke and Krupp, West Germany's second- and fourth-largest steel companies, is the first step toward a much needed consolidation of Western Europe's largest national steel industry. The new company, Krupp-Kloeckner Steel, will be able to close redundant, older facilities and to economize on distribution and raw materials costs. While backing Bonn's opposition to EC steel subsidies, the West German steel industry will demand matching subsidies if the influx of subsidized steel imports continues beyond next year. The Kohl government, however, is likely to continue its free market policies—pushing restructuring and shunning mass subsidies and protectionism.

cash flows at utilization rates that are low by historical standards. Capacity utilization in the West German steel industry should average 66 percent this year, compared to about 56 percent in 1983. In contrast, utilization rates were well above 80 percent in 1973-74. If operating rates continue to improve and prices hold up, West German steel companies could be in the black by 1985. After five consecutive years of losses, some mills are predicting break-even points by the end of this year. The metalworkers did not target steel during the 1984 strikes because of the precarious state of the industry.

Modernization and work force reduction are per-

mitting the West German mills to generate positive

Fighting To Recover

Foreign competition and sluggish demand dropped crude steel production from a peak of 53 million tons in 1974 to 36 million tons in 1983. During the period, West Germany lost market shares in intra-European trade and suffered in the US market from Japanese and South Korean competition. The independent Italian producers from the Brescia area were particularly aggressive in invading the West German market.

West German steel has weathered a prolonged crisis, but at a heavy cost. We estimate that crude steel capacity has been cut 9 million tons—or roughly 15 percent—since 1979. The industry work force shrank from 169,000 in 1975 to 116,000 by the end of last year. The Kloeckner-Krupp merger will reportedly cut another million tons of crude steel capacity and eliminate 3,000 more jobs. Even so, more cuts are needed. German steel executives told US Embassy officials last summer that the industry must shed another 10-15 million tons of capacity to run at peak efficiency.

The merger agreement coincides with a fledgling recovery for the West German steel industry. Steel output in 1984—aided by robust export growth, especially to the United States—should rebound to 40 million tons. The volume of West German steel product exports rose at a 30-percent annual rate during the first half of the year as competitiveness was buoyed by the strong dollar. In addition, severe price discounting, which undermined sales revenues during the early 1980s, is disappearing because of higher demand and EC minimum price rules.

Steel Politics

The steelmakers blame much of their plight on the bureaucracies in Brussels and Bonn. They argue that the EC should force larger capacity cutbacks on the much more heavily subsidized steel indus-

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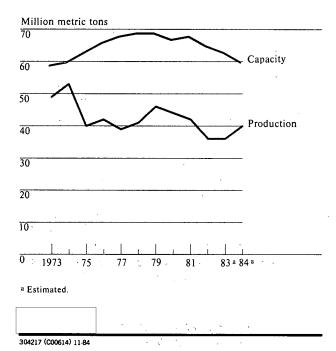
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West Germany: Crude Steel Capacity and Production, 1973-84^a



tries of other European countries, and they want Bonn to enact stringent antidumping rules to keep out subsidized steel imports. At the same time, they complain that Bonn is too stingy with financial assistance.

According to the US Embassy, steelmakers also believe that the industry's inclusion under EC steel policy has disadvantaged West Germany's thirdcountry trade, particularly with the United States. They argue that they have been unjustly harmed by quotas on EC carbon and specialty steel shipments to the United States that were implemented by the EC as a substitute for US antisubsidy penalties. The steelmakers feel their industry—the least subsidized in the EC—would fare better under bilateral agreements with the United States. West German steelmakers are concerned that the new round of orderly marketing agreements being negotiated between the United States and foreign steel suppliers will curb pipe and tube sales, and they, along with other EC producers, are anxious about possible diversions from the US market to Europe, especially by LDC steel producers.

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The Kohl government has conflicting objectives. While recognizing the need to consolidate the industry, it is alarmed by high unemployment rates in the steel-producing regions, where important state and local government elections will be held next year. To ease the pain of restructuring, Bonn has made a fund of DM 3 billion (US \$1 billion) in adjustment assistance available to steelmakers seeking to rationalize production. The public money will partly offset the costs of reinvestment and termination and retraining for redundant workers. The steelmakers complain that the bulk of the fund is reserved for employee programs, while the new investment subsidies are available only on a matching contribution basis. Bonn has resisted industry demands for unilateral import restraints, but is pushing the other EC countries to honor their commitments to ban steel subsidies by yearend 1985. Industry leaders, however, are skeptical that other EC states will follow through on the nosubsidy pledge.

Bonn's own record on the subsidy issue is not entirely clean. The Kohl government has been willing to modify its free market orientation when faced with job losses in politically sensitive regions. For example, it recently approved, subject to EC concurrence, another injection of public money to keep the Arbed Saar steelworks solvent. Economically depressed Saar is one of the states holding elections next year, and Arbed generates one-third of all industrial jobs in the area. The opposition Social Democrats have promised government takeover of Arbed if—as seems likely—they win the elections.

Merger Activity

A much ballyhooed merger plan between Thyssen, Germany's largest steel producer, and Krupp disintegrated last year when Thyssen dismissed as inadequate Bonn's offer of DM 500 million (\$160

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West Germany: Thousand metric tons Steel Production, 1982

Crude Steel	Rolled Steel
35,880	30,796
10,915	10,223
4,697	4,286
4,070	3,485
3,991	2,644
3,797	3,071
3,510	2,960
2,145	1,806
290	206
2,465	2.115
	35,880 10,915 4,697 4,070 3,991 3,797 3,510 2,145 290

million) in special consolidation assistance. The Thyssen-Krupp merger would have been consistent with the recommendation of a panel of experts that German steelmaking be consolidated into two regional centers: a Thyssen-Krupp combine operating in the Rhineland and a Kloeckner-Hoesch-Salzgitter group operating in the Ruhr valley.

Instead, the Kloeckner-Krupp merger will be a functional consolidation. Krupp—West Germany's largest specialty steel producer—will concentrate on stainless and high-grade products, while Kloeckner will streamline its basic steelmaking operations. An Australian minerals and mining firm will receive an equity stake in the new venture

The parent holding companies welcome foreign participation in the new company as a further means to divest their steelmaking operations.

Thyssen has indicated it is not actively seeking a merger partner, and will opt to consolidate by itself. Thyssen and the new Krupp-Kloeckner will together control over half of West German steelmaking. The remaining smaller companies will now be under increased competitive pressure to merge.

Outlook

Bonn will face hard choices over steel policy during the next several years. The steelmakers insist that their consolidation efforts will be undercut if subsidized imports continue. They issued a September position paper backing the government's opposition to an extension of EC steel subsidies into 1986; the paper also demanded, however, that Bonn provide matching subsidies if other EC members continue to aid their domestic steel industries beyond next year. Bonn realizes that expanded subsidies for steel would elicit demands for similar treatment from other declining industries and could provoke trade reprisals by the United States. Moreover, Bonn must decide what to do with Arbed Saarstahl, which may need many more years of government assistance to stay afloat.

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The Kohl government is likely to continue its present policy of minimal interference, pushing the steelmakers to trim and modernize while shunning mass subsidization or import restrictions. Short of protectionism, Bonn has little leverage over other EC steel producers' continuing subsidies beyond next year. Bonn will probably seek compensation for its industry in the form of higher steel production quotas.

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Australia's Economic Recovery: Hawke's Election Trump Card

Australia's popular Prime Minister Bob Hawke is relying upon a resurgent economy to guarantee his party's victory on 1 December. As the opposition struggles to find a campaign issue, the Prime Minister points to:

- The role of expansionary fiscal and monetary policies in spurring the recovery.
- A successful wage indexation scheme.
- A new national health insurance program.
- Recent tax cuts for lower and middle income earners.

At the same time, Hawke is reminding business leaders of reduced inflation, lower interest rates, extended deadlines for tax deductions on business investments, and the deregulation of the banking and securities industries.

With the polls showing that Hawke is preferred by two-thirds of the electorate, Labor appears headed for a landslide victory. Economic challenges to Hawke after the election, however, will be tougher. Australia's structural economic problems do not lend themselves to easy solution, and Hawke's own party may impede further policy reform.

Labor's Track Record

Since the Labor government was elected in March 1983, the Australian economy has done well by any standard:

- Inflation has been reduced by half—to about 6 percent—aided by declining import prices.
- Unemployment has fallen from a near record ll percent to below 9 percent.
- Real growth this year, near 6 percent, is the fastest Australians have seen in a decade.
- Farmers have had a bumper crop, as the fouryear drought has ended.
- Australia's energy and resource sector is booming again with economic recoveries in industrial nations, especially the United States.

Although external factors have sparked the recov-
ery, praise for his government's role in stimulating
and sustaining it is being heaped on Hawke by both
business and labor.

One of Hawke's greatest achievements was forging a consensus on economic policy among Australia's disparate economic interest groups by calling an economic summit in 1983 among government, labor, and business leaders. Stressing the need for slower wage growth to improve Australia's international competitiveness, Hawke was able to sell the prolabor Australian Conciliation and Arbitration Commission on long-term wage indexation. As a result, real wages fell last year and have risen only slightly in 1984. Nonetheless, man-hours lost to industrial disputes this year have been lower than in any year since 1967. At the same time, company profits have surged to their highest level as a share of GDP since 1973.

Hawke and Treasurer Paul Keating have also engineered an unprecedented deregulation of both the banking system and the securities industry designed to encourage private business investment. At least 10 foreign banks, including one or two US banks, will probably win Australian licenses in the coming year. On the domestic financial scene, Keating has increased the scope of both banks and nonbanking institutions; since their functions now overlap, a wave of mergers is under way.

The Election Budget—Something for Everyone

Media cynicism about the government's attempt to please everyone, including business, has not dampened the generally favorable reaction to Hawke's

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1985 budget. Keating boasted in his budget presentation of a threefold commitment for 1984-85: to cut the personal income tax, to reduce the deficit by more than US \$1 billion,² and to increase social spending, particularly for those in greatest need.

On the tax front, the majority of workers received the tax cut demanded by the Australian Council of Trade Unions (ACTU). Tailored to traditional Labor voters, the cuts are directed to low- and middleincome earners. Business leaders, meanwhile, are pleased with the increased tax incentives for investment in buildings, equipment, and oil exploration, and writeoffs for losses by subsidiaries. Hawke's social spending on welfare, unemployment assistance, and rent subsidies also are directed at some important political constituencies—young people, single adults, and pensioners.

Although critics argue that the budget is unnecessarily expansionary, this year's deficit will be lower than last year's. They argue that the increase in government revenue as a result of the recovery should be used to trim another US \$2 billion from the deficit rather than to expand social spending. Many spending items, however, such as interest on the national debt, do not lend themselves to economy moves.

Prospects Look Bright Through Early 1985

Although no one expects next year's economic performance to outdistance the expected 6-percent growth in real GDP for 1984, growth should remain above the rate for the last years of the Fraser government. For its part, the ACTU is strictly enforcing its pact with the Hawke government by revoking some of the privileges of rebellious unions and threatening to expel some of the more radical unions that have gone on strike.

Australia's external accounts, which have held up reasonably well during the expansion, are now

weakening—the one dark spot in the overall economic picture. The growth of exports will be moderated by a decline in agricultural output from the mid-1984 peak. With consumption and capital purchases increasing steadily, imports are expanding more than last year, creating a small merchandise trade deficit and widening the current account deficit.

The only economic issue that the opposition has seized on has been the government's postelection tax plans. Hawke has called for tax reform but has disclosed few specifics because Labor's natural constituency opposes the most obvious reform route, a broadly based consumption tax. Opposition leader Andrew Peacock warns that not only a capital gains tax but also a wealth tax and a pensioners' assets test loom on the postelection horizon if Labor wins. Australians, however, are inclined to believe that Keating will block any wealth tax, and more people than expected seem to favor some kind of capital gains tax to restrict tax evasion and to direct funds into more productive investments. The government's postelection tax package, however, will surely include a capital gains tax and probably a value-added or a sales tax covering some services and all goods except essentials.

Economic Challenges Beyond the Election

With Peacock's popularity rating falling below 20 percent, Australian observers are treating a Hawke victory as a foregone conclusion. The only questions are how large a majority Labor will achieve in the House of Representatives, and how strong the right wing will be in the party caucus. Hawke undoubtedly hopes to use the election mandate to advantage in his most formidable challenge—improving Australia's international competitiveness and sustaining long-term growth by restructuring the economy. He will also use his mandate to contain pressures from Labor's left and center-left factions to return to the party's "postponed agenda" for social reform.

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¹ Fiscal year 1 July 1984 through 30 June 1985.

² Australian dollars converted to US dollars at the prevailing (October 1984) rate of A 1.00 = US 0.83.

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Australian analysts agree that continued high growth depends on buoyant private investment and abor moderation. Although tax cuts have satisfied abor for now, media reports suggest that strikes will reappear next year if new union demands for productivity-based wage increases or a national pension scheme are not met. Increased union demands are likely because inflation, wage indexation, and consequent advances into higher tax brackets probably will wipe out all benefit from the August tax cuts by mid-1985. Moreover, tax reform and a broadening of the tax base will also spur labor's demands. One problem that threatens to confound Hawke's efforts is weaker-than-expected private business investment, despite higher company profits and retained earnings investment incentives and de-	Inflation is unlikely to return to its former high levels if wage pressures can be stemmed. Floating exchange rates, instituted in December 1983, allow Canberra to control the money supply more closely without worrying about a substantial deterioration of its foreign payments position. Keating, announcing the government's 1984-85 target for money supply (M3) growth at 8 to 10 percent, has said that monetary policy will be neutral. Observers in the press predict that, when the economy slows toward the end of 1985, Hawke will lose some of his popularity and Australia will lose the prices and incomes accord and many of the government's other achievements. We agree that Hawke will not be able to enact all the reforms he has placed on his second-term agenda, primarily because he is challenging longstanding traditions of	25X1 25X1
retained earnings, investment incentives, and de- regulation of the financial sector. Industry leaders	economic policy making. Still, slower economic	
stress that capital expenditure decisions are being	growth will probably be seen as insufficient cause	25X1
depressed by a rate of return that remains below that of the 1960s and 1970s. They suggest that the	to abandon Hawke's leadership.	20/(1
bulk of the recovery in industry profits comes from		25X1
cutting costs, including laying off workers and closing factories.		0EV4
closing factories.		25 X 1
Much of the economic outlook rests on Hawke's ability to maintain the prices and incomes accord. Business seems incapable of uniting on policy, so few observers expect successful opposition to a national pension plan, the top ACTU demand for the next wage negotiation phase. Labor costs are expected to rise even if wage indexation remains intact. If so, business investment will probably continue to lag.		25X1
Also on the negative side, the unemployment rate is		
unlikely to be lowered much further because of		
increased labor force participation and natural		
labor force growth. Optimistic forecasts claim that		
recorded unemployment will not fall unless GDP		
growth is sustained at least at 3.5 percent for		
several years. Bill Kelty, ACTU secretary, how-		
ever, believes 5-percent GDP growth is necessary.		
La view of structural problems in the Australian		
In view of structural problems in the Australian		
economy and the tenuous nature of the prices and		
incomes accord, such an extended period of high	•	25 X 1
growth seems unlikely.		

Egypt: Nuclear Power	•			
Program Falters			•	25X1

Lack of cash or a decent credit rating is thwarting Egypt's attempts at a nuclear power program. Low oil revenues have prevented Egypt from allocating as much foreign exchange to its nuclear program as it had planned, and Cairo's poor credit rating rules out financing on the commercial market. Construction of the El Dabaa plant, near Alexandria—the first phase of the Egyptian nuclear power program—will require substantial external financing from the home governments of interested companies. Egyptian officials hold the United States—and, specifically, the Export-Import Bank—responsible for their failure to secure financing for the El Dabaa reactor.

Low domestic energy prices would make it impossible for a nuclear power project to pay for itself. Egyptian officials generally agree that the energy sector needs reform, but because of their fear of popular unrest they are increasing prices cautiously. Moreover, Egypt lacks the industrial capability and trained personnel to construct, operate, and maintain a nuclear power plant. A foreign-constructed turnkey plant would lessen this difficulty but would be politically unpalatable to the Egyptians.

Egypt's Nuclear Plans

According to US Embassy reporting, Cairo's current interest in nuclear power development stems from a 1978 US-Egyptian energy assessment that recommended nuclear power as a way to conserve oil for export. In addition, Egyptian proponents of the program probably believe that Egypt's reputation as the intellectual center of the Arab world will be reaffirmed by its mastery of a key advanced industrial technology.

US Embassy reporting indicates that Egyptian officials planned early in 1983 to award a contract to the French for the construction of two power reactors at El Dabaa, probably in the hope of stimulating international competition to build an additional six units by the year 2005. By March 1983, however, the Egyptian Nuclear Power Plant Authority had invited US, West German, and French companies to bid on the first two reactors. US and West German firms and a French-Italian consortium have submitted proposals.

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Financial Problems

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A lack of money has held back Egypt's nuclear energy program from the start. Cairo established an Alternative Energy Fund in June 1981 to channel petroleum revenues into nuclear power development, but declining oil revenues caused officials to scale back planned deposits from \$500 million to \$150 million per year. The IMF recently reported there is about \$700 million in the Fund. Nevertheless, the Egyptians are seeking very soft financing to cover 80 percent of the cost of the first reactor.

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Trade officials in France, West Germany, and Switzerland have been eager to secure the El Dabaa contract. The finance ministries in these countries, however, have expressed doubt about Egypt's ability to repay the loans. Their concerns center on Egypt's sagging international credit rating and its ability to implement such a complex undertaking. The confidence of foreign lenders eroded further when Egypt was late on its first payment for enriched uranium fuel from the US Department of Energy, before it even issued firm specifications for its first power reactor.

Concerns About the Egyptian Economy

The concerns of Western lending agencies about Egypt's future ability to repay loans are, in our view, well founded. We expect that declining oil exports will severely limit Egypt's foreign exchange earnings by the end of this decade. Even if the annual growth of domestic energy demand fell substantially—from the present 13 percent to an optimistic 5 percent by 1990—we expect annual oil revenues—barring new discoveries—to fall from about \$2.3 billion this year to around \$1 billion by the end of the decade.

Cuts in consumption are contingent on continued price rises and increased use of natural gas for industrial and household purposes. Prospects for nonoil exports are limited, and we expect growth of earnings from Suez Canal tolls and remittances by expatriate workers to slow. Although nuclear development would free more oil for export, that saving would not come before the drop in oil revenues substantially worsened Egypt's financial situation.

Cairo is unlikely to enact the energy price reforms to make the El Dabaa project self-sufficient. According to Prime Minister 'Ali, a 20-percent increase in electricity rates—promised during the summer—probably will be postponed until next February. Moreover, even substantial rises in energy prices would not immediately solve Egypt's financial problems. Such price increases probably would be accompanied by proportional budget sup-

port for public-sector firms affected by the adjustments and by substantial wage hikes to offset the resulting surge in inflation. These measures would erode the budgetary benefits of increased energy prices.

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Blaming the United States

According to Embassy reporting and public statements, Egyptian officials primarily blame the United States for their failure to secure financing for El Dabaa. The Ex-Im Bank decided in August 1983 not to offer credits for the reactor project because it believed low Egyptian electricity rates would be insufficient to amortize the costs of the plant and expensive support facilities such as power lines, a water supply, and a port. The Bank informed lending agencies in other Western governments of the reasons for its decisions' arousing Cairo's anger. According to US Embassy reporting, Egyptian officials apparently believe the United States also urged other Western nations not to provide credits for El Dabaa and expressed a lack of confidence in the Egyptian economy as a whole.

According to Embassy reporting and recent US academic studies, Egyptian officials also believe that the United States has reneged on a promise to assist the nuclear power program in return for Egyptian diplomatic cooperation on the Sinai Disengagement Accord in 1974 and for ratifying the Nuclear Nonproliferation Treaty (NPT) in 1981. While US representatives have told the Egyptians that Washington only offered technical cooperation and training, we believe that US offers in 1981 to sell enriched uranium and in early 1983 to provide surplus nuclear power plants from the Tennessee Valley Authority may have contributed to the Egyptian misperception.

Outlook

Cairo will press the issue of financing for El Dabaa with US officials until it makes a decision on

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contract bids, possibly this month. President Mu- coarak's failure to secure financing during talks with French and West German officials in early November is likely to make the Egyptians even more convinced that US support for the project is critical.	
Egypt probably will continue to avoid a close association with the United States when nuclear energy is discussed in multilateral forums. As a member of the IAEA Board of Governors, Cairo is likely to side frequently with those nonaligned nations that criticize major supplier states for withholding nuclear technology and assistance. The upcoming NPT Review Conference will provide Egypt with another opportunity to chide the United States for not assisting its nuclear power program. Cairo has strong economic and strategic reasons to continue its close relationship with the United States, however, and it is not likely that disagreement on El Dabaa will impair other aspects of US-Egyptian relations.	
Over the next two years, lack of foreign financing would force Egypt to shelve most of its nuclear power program quietly. Substantial delay in construction of the first reactor probably would lead Cairo to request cancellation of its contract with the United States for uranium enrichment. The Egyptians almost certainly would insist that the contract's penalty clauses were void because of US refusal to finance El Dabaa.	

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Mexico: Border Assembly Operations Expanding

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The peso devaluations since the beginning of 1982 and favorable treatment from the de la Madrid administration have spurred the growth of assembly plants along the US border. These firms, which import US raw materials and components and reexport assembled goods under special tariff provisions to US markets, number about 650 and employ about 215,000 workers, up 75 percent since yearend 1982. The expansion may be short lived, however, due to labor shortages, inadequate physical facilities, and increasing costs. In addition, because concessions given to assembly operations are an exception to foreign investment policy and conflict with nationalistic industrial goals, the government might decide to discourage these ventures.

Growth of the Program

Mexico City initiated its assembly program in 1966 to reduce chronic unemployment along the border, which had been aggravated by the end of the US bracero program a year earlier. These plants were exempted from Mexican import duties on material inputs and equipment, local content regulations, and legislation requiring a certain degree of Mexican ownership. Regulations revised in 1972 allow firms that had been limited to a 20-kilometer strip along the border to locate in the interior. Such plants manufacture a variety of products including electronic components—about one-half the total value added by these firms—aircraft and auto parts, sports equipment, chemicals, and textiles.

Although most in-bond operations are US owned, Japanese electronics and auto parts firms have established a significant and growing presence. By locating in the United States and setting up a Mexican-border subsidiary, Japanese firms skirt

The Tariff Incentives

United States Tariff items 806.30 and 807.00 are essential to Mexico's assembly industries. Both items permit tariff reductions on the reimport of products assembled abroad from US components:

- Item 807.00 is by far the more important provision. Under it, imported articles are subject to duty upon the full value of the imported product less the value of the US-fabricated components. The US components must retain their physical identity in the final product, but no further processing in the United States is required. Almost 99 percent of Mexican assembly exports use this tariff provision.
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- Item 806.30 applies only to metal articles (except precious metals) that are exported for some processing and then returned to the United States for further processing. Duty is payable only on the value of the foreign processing. The original intent of this legislation was to allow manufacturers in the Detroit area to ship metal products to nearby Canadian firms that had particular processing equipment or when their own equipment broke down. Only 1 percent of Mexican assembly exports use this provision.

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US import restrictions. Mexico's low wages and proximity to the US market make it competitive with the Asian assembly industry.

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The program expanded steadily and by 1981 comprised 605 plants and 130,000 workers. In 1982,

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assembly declined slightly as an overvalued exchange rate, climbing wages, and new exchange controls sharply cut profits.

Since taking office in December 1982, President de la Madrid has introduced a number of measures favorable to assembly operations. Some actions, such as a sharp devaluation of the peso and reduced exchange restrictions, were in response to Mexico's growing economic crisis. Others, such as a substantial easing of border investment procedures, were directly aimed at reviving the assembly activities. Moreover, a new code for assembly firms published in August 1983 rejected calls for mandatory increases in local content and for limits on foreign ownership, but offered incentives for more Mexican participation.

Industry Performance in 1983-84

These policy actions, plus the strong economic recovery in the United States, have resulted in a substantial increase in production by in-bond industry over the past two years. According to US statistics, Mexican exports from such firms increased 31 percent in 1983. Mexico's Foreign Trade Institute reports that over 40 new plants opened in the first six months of 1984. We project that the value added this year will increase 40 percent over last year's total and exceed \$1 billion. The total value of exports to the United States should exceed \$4.6 billion, a 25-percent increase over 1983.

Limits to Expansions

Assembly operators increasingly fear that Mexico will be unable to keep up with requirements for services and labor. Rapid expansion in Juarez, for example, has already filled industrial parks and is straining electricity and water supplies. Public transportation in most border cities is also inadequate to support an increased work force, and problems will increase as new plants locate farther from urban centers. Moreover, highway and bridge connections between US and Mexican border cit-

Mexico: Export Earnings From Border Industries

Billion US \$

	1981	1982	1983	1984 a
Value added in Mexico	0.98	0.85	0.83	1.16
Total assembly exports to the United States	2.71	2.85	3.72	4.65
Total exports to the United States	13.80	15.60	16.80	18.00

a Estimated.

ies—particularly between El Paso and Juarez—are also becoming strained.

Growing shortages of both skilled and unskilled workers aggravated by high labor force turnover are also limiting prospects for expansion. Turnover was already a chronic problem because most workers are young women who often leave when their families move away, or when they marry or become pregnant. The rapid expansion of firms has created a sellers' market for workers. As a result, some workers jump from plant to plant seeking better fringe benefits—all plants continue to pay the legal minimum wage. In addition, the border area is a relatively high-cost area, unattractive to many Mexican workers.

Plant managers have adopted strategies to deal with labor shortfalls.

firms have raised noncash benefits, which are not subject to employer taxes, substantially in 1983 and 1984. Firms are also recruiting outside their traditional labor pool by hiring older women, workers with less education, and more men. According to press reports, government officials supervising the program believe about one-third of assembly workers will be male by December 1984, an increase of about 25 percent from a year before.

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Decisionmaking in Mexico City

Government policies could dampen investor enthusiasm, although recent Embassy reports suggest Mexico City once again plans to promote assembly operations in the states of Yucatan, Durango, Jalisco, and Zacatexas to combat high unemployment. Plant owners, however, are aware that Mexico City often regards them as a necessary evil, and they are watching closely for signs that the government may tighten regulations on these industries. A long series of Mexican legislation—including the foreign investment law, the technology-transfer law, and specific industrial decrees—show a trend to increased domestic control over foreign investors and to greater participation by local businesses. Because most assembly firms do not sell to the domestic market, they have been exempted from most of these regulations. Nevertheless, government representatives have stated they would like the industry to use more Mexican inputs. They have also asked Mexican businessmen to invest more in the assembly sector, which in mid-1983 was about 20 percent Mexican owned. Despite these pressures, we do not believe that tighter domestic content or ownership regulations are imminent.

Policy decisions on exchange rates will also affect future investments in assembly operations. The recent spurt in activity has been directly attributable to the peso devaluation and the resulting sharp fall in wages in dollar terms. At present, however, Mexican officials are allowing the peso to appreciate. We calculate that this year's inflation rate will approach 60 percent, while the peso will have fallen in value at an annual rate of only 33 percent. To serve broader policy concerns, we believe Mexico City will continue to let the peso float upward. As a result, higher dollar costs will reduce the profitability of these ventures.

Likewise, Mexican wage and labor policies will also influence potential investors and current firms. Wage costs are considerably higher in Mexico than in many other LDCs. The legal minimum wage—currently a little over \$4.00 per day—represents only a fraction of labor costs. Mandatory contributions to the social security system and the govern-

ment housing fund, as well as other labor expenses and fringe benefits, add to the cost of labor. Real wages fell in 1983; we believe they will decline again this year. Nonetheless, Mexico City has important midyear elections scheduled in 1985 and, for this reason, may grant larger wage adjustments next January and again in June or July. In addition, increased unionization—the US Embassy estimates that only one-third of the plants are unionized—could drive up wage costs. Any of these factors could influence not only future investments but even current ones. Because the actual investment in Mexico is fairly small—all machinery, for example, is imported inbond—it is easy for these firms to move elsewhere.

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The US-Mexico Connection

Mexico is the largest recipient of US components destined for assembly abroad, receiving 32 percent of all US component exports and 37 percent of such US exports to LDCs. Moreover, the majority of the assembly firms are subsidiaries of American companies. In large measure, these industries owe their existence to special provisions in the US tariff codes. Although US labor groups have supported the repeal of these tariff provisions, most academic studies show that assembly operations in Mexico do not represent a net drain on American jobs. These studies note that many American firms would move all of their operations abroad if US tariff provisions did not allow them to remain competitive. In addition, assembly industries directly create US jobs in the transportation industry and in such service industries as warehousing.

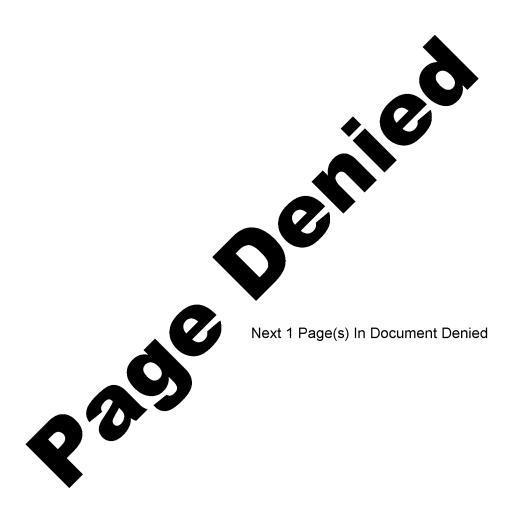
Similar studies show that Mexican assembly workers spend a substantial share of their salaries in US border cities, although the amount has declined since the devaluations. While recent Embassy and business reports indicate some workers are crossing into the United States, we do not believe the numbers are significant. Assembly workers have not historically been a major source of illegal migration.

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